

with the ILEC, it may artificially increase its infrastructure spending in the high-cost area, which would increase the support to the CETC. Such a result would not provide efficient benefits to consumers and would cause the fund to balloon.

(2) If the CETCs costs are higher than the ILEC, then, unless CETCs are denied support for providing service in that high-cost area, the total size of the fund would increase.

To achieve the goals of universal service, the FCC should develop a simplified, unified, forward-looking high-cost support mechanism that replaces the current modified embedded cost mechanism, which was originally developed to serve as a means to ease LEC transition toward forward-looking costs. Uniform levels of universal service support should be available to facilities-based incumbent and competitive carriers serving areas where neither the incumbent nor competitors could or would be motivated to provide the supported services at an affordable rate without access to universal service subsidies. The high-cost universal service mechanisms should encourage economic efficiency so that required support amounts are rational and eventually stabilize or decline, depending upon advances in efficiencies and technologies.

Whatever changes are made to the high-cost mechanisms, universal service support must continue to be distributed in both a competitively and technologically neutral manner, as required by the Act. That way, consumers in rural and high-cost areas, the intended beneficiaries of universal service, will have access to the same types of telecommunications and information services that are available to consumers in urban areas, both in terms of quality and cost.

I. THE CURRENT REALITY OF HIGH COST SUPPORT

a. The Growth of the Fund is Caused Primarily by ILECs Not CETCs.

The wireless industry is a major contributor to universal service and a limited recipient of high-cost support, and is therefore uniquely situated to comment on proposals to reform the high-cost support mechanisms. In 2003, CMRS providers were responsible for \$1.4 billion or 22% of federal universal service contributions, while receiving only \$175 million or 3% of all federal universal service subsidies.² In contrast, local exchange carriers (LECs) were responsible for

² Universal Service Administrative Company, 2003 Annual Report, at 26, *available at* <http://www.universalservice.org/Reports/>; Commission Seeks Comment on Staff Study Regarding Alternative Contribution Methodologies, CC Docket Nos. 96-45, 98-171, 90-571, 92-237, 99-200, 95-116, 98-170, Public Notice, FCC 03-31, at 5 (rel. Feb. 26, 2003) (*Staff Study Public Notice*).

\$1.7 billion or 27% of federal universal service contributions, while receiving \$4.4 billion or 78% of all federal universal service subsidies.³

From 2000 through 2003, the FCC's high-cost universal service mechanisms grew approximately 46%.⁴ In spite of alarmist rhetoric about growth in support going to competitive ETCs, the vast majority of growth in the high-cost fund is the result of increased support for incumbent LECs. In fact, from 2000 through 2003 incumbent LECs were responsible for 87% of growth in the high-cost fund.⁵ From 2000 through 2003, incumbent LEC support increased by roughly \$900 million, from \$2.2 billion to over \$3.1 billion.⁶

During this period, incumbent LECs received approximately \$55.73 for every \$1.00 of support received by competitive ETCs.⁷

Although in percentage terms the wireless industry's share of high-cost support has grown over the last few years, its take in real numbers remains very small. The reality is that incumbent LECs continue to receive approximately 93% of high-cost funding even though there are now almost as many wireless handsets (approx. 169 million) as incumbent LEC access lines (approx. 180 million).⁸ In 2003, rural incumbent LECs, which serve only approximately 12% of

³ Universal Service Administrative Company, 2003 Annual Report, at 26, *available at* <http://www.universalservice.org/Reports/>; *Staff Study Public Notice*, FCC 03-31, at 5.

⁴ *See*, Universal Service Administrative Company, 2003 Annual Report, at 26, *available at* <http://www.universalservice.org/Reports/>; Universal Service Administrative Company, 2000 Annual Report, at 30, *available at* <http://www.universalservice.org/Reports/>.

⁵ *See*, Universal Service Administrative Company, 2003 Annual Report, at 26, *available at* <http://www.universalservice.org/Reports/>; Universal Service Administrative Company, 2000 Annual Report, at 30, *available at* <http://www.universalservice.org/Reports/>.

⁶ Universal Service Administrative Company, 2000 Annual Report, at 30, *available at* <http://www.universalservice.org/Reports/>; Universal Service Administrative Company, 2003 Annual Report, at 26, *available at* <http://www.universalservice.org/Reports/>.

⁷ Based on USAC data *available at* <http://www.universalservice.org/hc/whatsnew/072004.asp> (visited 7/30/04) (Approximately \$11.18 billion for incumbent LECs versus \$200.6 million for competitive ETCs).

⁸ *See* Universal Service Administrative Company, Federal Universal Service Support Mechanisms Fund Size Projections for the Third Quarter of 2004, at Appendix HC05 (filed Apr. 30, 2004). Given that it can take many months (if not years) for a competitor to obtain its ETC designation and begin receiving support, CTIA's analysis rightly excludes those competitors

the nation's wireline access lines, received approximately three-quarters of high-cost universal service support.⁹

b. Providing Support to CETCs Based on ILEC Per Line Costs Supports the Goals of the Act.

Some have commented that because wireless providers are more efficient in the provision of service in high-cost areas than the ILECs, wireless CETCs receive a "windfall" under the current mechanism. This is simply not true. The entire purpose of a per-line support methodology is to encourage carriers that are more efficient than the incumbent to enter the market. If it is more efficient, then it will enter. However, a competitor will not receive more support in total than the incumbent, simply because at the outset it will have far fewer lines in service than the incumbent. Thus, even a very efficient competitor will need every dollar of support to construct, improve and maintain new networks to compete with the incumbent and respond to all reasonable requests for service.

Perhaps most importantly, however, the amount of support received cannot be fairly characterized as a windfall because, any so-called excess funding to a competitor must be invested in its network facilities, which only serves to accelerate the competitor's ability to construct new wireless infrastructure to better serve consumers. In short, a competitor is forced to use the funds for the benefit of consumers. Likewise, there is little doubt that efficient competition provides a parallel incentive for rural ILECs to reduce their costs as well, easing the long-term burden on the fund.

The customer benefits under the current system because, competitors are encouraged to enter high-cost markets. But competition is not an end unto itself. It is merely a means by which to achieve the underlying goals of the Act; lower costs and new and innovative services (increased customer value). Competitors will not seek investment dollars and investors will not provide such dollars when the competitor has to create a business model that not only provides a

listed on USAC's charts that have ETC petitions still pending or are otherwise not yet eligible to receive support by operation of the time lags in the FCC's line count reporting rules.

⁹ Universal Service Administrative Company, 2003 Annual Report, at 26, *available at* <http://www.universalservice.org/Reports/>; Universal Service Administrative Company, Federal Universal Service Support Mechanisms Fund Size Projections for the Third Quarter of 2004, at Appendix HC05 (filed Apr. 30, 2004).

more efficient, higher customer value proposition than the incumbent provider, but also must be so much more efficient, and create so much more value that it can also offset the unequal financial subsidization provided to the incumbent. Under the current mechanism, a competitor entering the market starts on a level playing field with the ILEC, with regard to USF. If the CETC is or becomes more efficient than the ILEC, then it will succeed and the customer will benefit. If the CETC is not more efficient and does not believe that it will be able to achieve those efficiencies, it will not expand in those areas, and support will not be wasted in those areas.

c. The Current Support Mechanism Promotes ILEC Inefficiency.

The FCC's embedded cost mechanism creates incentives and opportunities for ILECs to have higher embedded costs to receive more support. As far back as 1997, the FCC agreed with the Joint Board that "support based on embedded cost could jeopardize the provision of universal service."¹⁰ In particular, the FCC observed that:

[E]mbedded cost provide[s] the wrong signals to potential entrants and existing carriers. The use of embedded cost would discourage prudent investment planning because carriers could receive support for inefficient as well as efficient investments. . . . [T]he use of embedded cost to calculate universal service support would lead to subsidization of inefficient carriers at the expense of efficient carriers and could create disincentives for carriers to operate efficiently.¹¹

These incentives for inefficiency result in increased costs and corresponding demands for support. Between 2000 and 2003, the national average loop cost for rural ILECs grew from approximately \$337 per loop per month to approximately \$378 per loop per month. Therefore, despite industry-wide efficiency gains, advances in technology, and amortization of depreciated equipment, high-cost universal service subsidies continue to increase rather than decrease in size over time.

In practice, the FCC's high-cost support mechanisms compound incentives for inefficiency inherent in embedded cost support mechanisms. For example, the high-cost support mechanisms discourage ILECs from taking advantage of economies of scale normally associated with combining operations. This is because under the high-cost loop support mechanism smaller

¹⁰ See *Universal Service First Report and Order*, 12 FCC Rcd 8776 at 8901 para. 228.

¹¹ See *id.*

rural ILECs are eligible for more high-cost loop support than larger ILECs.¹² In addition, the local switching support mechanism arbitrarily makes ILECs with less than 50,000 access lines in a study area eligible for switching support.¹³ ILECs that increase their customer base risk qualifying for less or no high-cost support.

The embedded high-cost mechanisms' preference for small carriers also creates incentives for carriers to appear small when, in fact, they are much larger. Incumbent LECs do this by maintaining numerous "study areas" in a given state. High-cost loop support and local switching support are based on a rural incumbent LEC's embedded costs averaged at the "study area" level.¹⁴ By acquiring partial or complete study areas or by virtue of having operated more than one study area in a given state prior to November 15, 1984 (when study area boundaries were frozen), numerous carriers currently operate in more than one study area in a given state.

By operating in multiple study areas in a given state, certain carriers receive more high-cost universal service support than they would receive if their study areas within a state were combined.¹⁵ If these carriers were required to combine their study areas to reflect their actual service territory in a given state, they (and their CETC competitors) potentially would qualify for less support. Even if carriers combine their operations within a state for universal service purposes, they still have incentives to balkanize their operations among the various states – because support would be based on costs average at the state level.

Finally, the embedded cost mechanisms often do not target support to high-cost areas. Support for rural and rate-of-return incumbent LECs is based on the carrier's average "study area" costs. Study areas often include both high-cost and low-cost wire centers. This is especially true for larger rural incumbent LECs that in some cases serve several 100,000 customers in a state. While rural incumbent LECs have the option of disaggregating support to

¹² See 47 C.F.R. § 36.631 (providing more support to rural incumbent LECs with less than 200,000 working loops in a study area).

¹³ See 47 C.F.R. § 54.301. It is noteworthy that the local switching support mechanism also does not require qualifying carriers to have high costs in order to receive support. See *Referral Order*, FCC 04-125, at para. 10.

¹⁴ See 47 C.F.R. §§ 36.601-36.631.

¹⁵ See *Referral Order*, FCC 04-125, at para. 12.

high-cost and low-cost zones, disaggregation is not required.¹⁶ A rural incumbent LEC's failure to effectively disaggregate support to high-cost zones could result in an over payment of the CETC in portions of a study area where costs are actually low but because support is averaged over the entire study area, the CETC support level is artificially high. .

II. THE NECESSARY REFORM

a. ILEC Support Mechanism.

The FCC must transition rural ILECs to a single high-cost mechanism that calculates support based on forward-looking economic costs. In 1997, the FCC specifically determined that universal service support should be based on the forward-looking economic cost of constructing and operating the network facilities and functions used to provide the supported services, it was also determined that rural carriers must eventually shift to a forward looking cost model. In May 2001, through the Fourteenth Report and Order, rural LECs were again put on notice that competition is coming and that they must use the five year transition period provided by the modified embedded cost system to become more efficient and prepare for the day when they must compete on a level playing field with other carriers seeking to enter their markets.

The ultimate result of reform would be a single high-cost support mechanism that replaces the modified embedded high-cost mechanisms currently in place. Under such a mechanism, support for all eligible carriers will be based purely on efficient, forward-looking economic costs of serving a geographic area. Necessary reform will likely result in a short-term increase in the high-cost fund for both wireline incumbents and wireless competitors, but such reforms are necessary to encourage efficient carriers to enter so as to protect the long-term viability of universal service. Over time, however, such reforms will decrease the need for universal service subsidies by encouraging and rewarding efficiency and better targeting the right amount of support to high-cost areas.

b. CETCs Must Receive the Same Per-Line Support as the ILEC.

i. CETC Support Based on its Own Costs Would Benefit ILECs at the Expense of Consumers.

Proposals to give the incumbent and competitive ETCs in a particular market unequal support levels must be rejected. Specifically, the Joint Board should reject blatantly

¹⁶ See 47 C.F.R. § 54.315. Approximately 20% of rural carriers filed disaggregation plans.

discriminatory proposals to give CETCs support based on their own embedded or forward-looking costs when those costs are less than the incumbent carrier's costs, but not when competitive ETC costs are the same or more than the incumbent's costs. An unequal support mechanism is exactly the type of implicit subsidy that the Act required to be removed. Such a mechanism will significantly handicap CETCs in the competitive marketplace and retard consumers' ability to choose the service that best suits their needs. In short, if regulators slow wireless carriers' ability to invest in rural areas, consumers are harmed because they will not have the benefit of high-quality networks that enable them to choose wireless as their primary source of telephone service.

Moreover, consumers will be denied the benefits of the CETC efficiency. Where support is equal for the ILEC and the CETC, potential CETCs can evaluate whether they can provide greater customer value (either lower cost or increased service), while still providing the CETC with a return on their investment. If the CETC can offer such efficiency, then it will enter the market. That is happening today. In Minnesota and Wisconsin, for example, Midwest Wireless was designated as an ETC in its service territories in 2003. Since that time, Midwest Wireless has deployed infrastructure in rural, high-cost areas that provides, among other benefits: emergency health and safety benefits (E-911, emergency service provider ability to communicate while reacting to an emergency situation, etc.), mechanisms to prevent emergencies (e.g., calling for help when stranded in inclement weather or for roadside assistance in very rural areas), increased economic development (farmers, service professionals, sales personnel and others are able to conduct business when away from a stationary land-line connection), and high-speed (Broadband) Internet in rural areas, in the form of a 1xRTT network that operates in conjunction with Midwest Wireless' wireless voice network and a 802.11 network that shares facilities with the wireless voice network.¹⁷

If potential CETCs are faced with the prospect of unequal support they will not choose to enter the high-cost markets. By way of example, assume an ILEC's cost is \$10.00 to provide

¹⁷ Likewise, wireless ETCs have brought universal service to other rural and insular areas that traditionally have been underserved or unserved by ILECs. The FCC and certain States have recognized that certain regions of the country (e.g., Appalachia, the Mississippi Delta, Tribal Areas, areas of North Dakota) have lower telephone penetration rates than other regions in the country and that the wireless industry can be a key player in deploying services to these areas.

service to a customer in a high cost area and the potential CETC's cost is \$7.00 to provide service to the same customer. Each carrier adds a desired margin to their cost of \$1.00. In an environment where support is equal between carriers (for purposes of this example, support = \$5.00 based on the ILEC's costs, using the modified embedded cost methodology, the CETC, as a result of its efficiency, has \$3.00 per customer with which to reduce prices or increase value. In that environment, potential CETCs should choose to enter the market and the resulting competition will benefit consumers by forcing the various providers to compete based on price, service quality, service variety, customer service and other mechanisms. In short, the consumer benefits.

If each carriers' support is based on its own cost, consumers will be denied the benefit of competition, either because there will be no competition, or because carriers will use support inefficiently. CETCs would have little or no incentive to compete and/or invest in high-cost areas in which they can provide efficiency. Under the example above, if the support were based on each carriers' respective costs, (\$5.00 for the ILEC and \$3.00 for the CETC) then the CETC is unlikely to enter the market because their ability to entice customers away from the ILEC has been effectively eviscerated. The CETC would have little or no money with which to add value to the customer. While preservation of monopoly certainly would benefit the ILEC, it will not benefit the consumer as contemplated by the Act.

Moreover, the ILECs would have no motivation to become more efficient under such a mechanism, because reduced cost would decrease support, thereby reducing their advantage over the CETC. Again, the consumer is denied the benefits of competition.

ii. Support Must Be Competitively Neutral

In working towards reformation of the current high-cost support mechanisms, the Act demands that such support must be available on a technologically- and competitively-neutral basis. The goal of competitive neutrality in the distribution of universal service funds is not just worthwhile policy goal. It is required by statute. As the Rural Task Force noted during the course of its deliberations, "Section 254(b) and 214(e) of the 1996 Act provide the statutory framework for a system that encourages competition while preserving and advancing universal service."¹⁸ The FCC noted this statutory mandate in the First Report and Order, when it stated

¹⁸ Rural Task Force, *White Paper 5: Competition and Universal Service*, at 8 available at <http://www.wutc.wa.gov/rtf> (hereinafter "White Paper 5") (2000).

that “universal service mechanisms and rules” should “neither unfairly advantage nor disadvantage one provider over another, and neither unfairly favor nor disfavor one technology or another.”¹⁹

c. Accurately Targeting Support to High Cost Areas Will Limit Fund Growth.

The importance of accurately targeting high-cost support increases with each new CETC designation. As more new CETCs are designated in areas served by rural ILECs that have chosen Path 1 disaggregation, the problem of over- and under-compensation are exacerbated. For example, Virginia Cellular was designated in a very high-cost area where the support levels are inordinately low due to Path 1 disaggregation by the rural ILEC. At the same time, Virginia Cellular was denied ETC status in a lower-cost wire center of another Path 1 ILEC because the FCC concluded the averaged per-line support would be excessive.²⁰

The Rural Task Force took this issue up five years ago and concluded, with a consensus of wireless and wireline carriers, that disaggregation is needed to more accurately target support and protect rural ILECs from subsidized competitive entry in low-cost areas. Without any supporting evidence whatsoever, the FCC speculated in its *Highland Cellular* decision that disaggregation may not always protect ILECs,²¹ and the Joint Board regurgitated the same statement in its recent recommendation.²² States that have carefully considered this matter have properly rejected this unwise and unsupported policy shift.²³

It is widely accepted that disaggregating support to the wire center level is not an onerous task, even for small rural ILECs. The Commission should modify its rules to require all ILECs to

¹⁹ See *Universal Service First Report and Order*, 12 FCC Rcd at 8801 para. 47.

²⁰ See *id.* at 1579-81.

²¹ *Highland Cellular, Inc.*, 19 FCC Rcd 6422, 6437-38 (2004) (“*Highland Cellular*”).

²² See *2004 Recommended Decision*, *supra*, 19 FCC Rcd at 4279.

²³ See Supplemental Comments of the Minnesota Public Utilities Commission in CC Docket 96-45, filed May 14, 2004; Supplement to Petition by the Colorado Public Utilities Commission in CC Docket 96-45, filed May 14, 2004; Northwest Dakota Cellular of North Dakota Limited Partnership d/b/a Verizon Wireless et al., Case No. PU-1226-03-597 et al. (N.D. PSC, Feb. 25, 2004) at pp. 10-12 (“Dakota Cellular Order”); AT&T Wireless PCS of Cleveland, LLC, Docket No. UT-043011 (Wash. Util. & Transp. Comm’n, 2004) at p. 9 (“AT&T Washington Order”); Easterbrooke Cellular Corp., Recommended Decision, Case No. 03-0935-T-PC (W.V. PSC, May 14, 2004) at p. 55 (“Easterbrooke Cellular”).

immediately disaggregate support under Path 2, at least to the wire center level. This one action will greatly improve the transparency of the system so that competitors can make a more reasoned choice as to whether to enter some areas. If support is moved out of low-cost areas, some carriers will likely decline to enter. Alternatively, the Commission should require such disaggregation immediately upon designation of a competitive ETC in any portion of an ILEC study area.

d. The System Should Reward Efficiency and Reduce the Long-term Need for Support

If properly designed, a forward-looking methodology for calculating high-cost universal service will do a far better job than an embedded cost system at directing appropriate levels of high-cost support to eligible carriers serving high-cost areas. Because a forward-looking mechanism provides an objective measure of efficient costs, it also will provide the appropriate incentives for investment, innovation, and entry into the marketplace.²⁴ As the FCC observed in the *Universal Service First Report and Order*, in comparison to embedded cost support, “a forward-looking economic cost methodology creates the incentives for carriers to operate efficiently and does not give carriers any incentives to inflate their costs or to refrain from efficient cost-cutting.”²⁵ Moreover, “in the long run, forward-looking economic cost best approximates the costs that would be incurred by an efficient carrier in the market.”²⁶

A forward-looking mechanism such as that currently used for non-rural incumbent LECs also targets support to small geographic areas, thereby ensuring that “sufficient” support is available in high-cost areas. A forward-looking mechanism, therefore, will better ensure that consumers in high-cost areas have access to telecommunications services that are comparable to those available in urban areas, in terms of both rates and quality. Over time, a high-cost support system based on forward-looking costs also will reduce the need for support.

The FCC has squarely rejected arguments that the FCC indefinitely should maintain embedded cost support mechanisms for rural carriers.²⁷ The FCC concluded that “after a

²⁴ See *Universal Service First Report and Order*, 12 FCC Rcd 8776 at 8899 para. 224.

²⁵ See *id.* at 8900 para. 226.

²⁶ See *id.* at 8899 para. 224.

²⁷ See *id.* at 8934-35 paras. 291-292.

reasonable period, support for rural carriers also should be based on their forward-looking economic cost of providing services designated for universal service support.”²⁸ In the *Rural Task Force Order*, the FCC described numerous flaws with the Rural Task Force’s conclusion that forward-looking support was not suitable for rural telephone companies.²⁹ Indeed, the FCC concluded that all of the Rural Task Force’s complaints about forward-looking support could be addressed by updating model inputs and using different benchmarks and averaging conventions.³⁰

In the *Rural Task Force Order*, the FCC also stated “[w]e disagree” with arguments that “only an embedded cost mechanism will provide sufficient support for rural carriers.”³¹ The *Rural Task Force*’s complaints about forward-looking support entirely overlooked the fact that universal service reform first and foremost is about ensuring that *consumers* in high-cost areas have access to telecommunications and information service at rates that are reasonably comparable to rates charged for similar services in urban areas.³² Courts have emphasized that the Act demands sufficient funding for *customers*, the intended beneficiaries of universal service, not *providers*.³³ Moreover, excessive support can violate the “sufficiency” requirement in the Act.³⁴ The FCC, therefore, must move forward with necessary reforms to the high-cost universal service mechanisms.

CONCLUSION

Passage of the 1996 Telecommunications Act provides an explicit expression of the twin goals of competition and advancement of universal service. Achieving these explicit goals requires a fundamental reform of the high-cost universal support mechanisms. Reform must produce a forward looking high cost mechanism which is distributed in a competitively and

²⁸ See *id.* at 8934 para. 291.

²⁹ See *Rural Task Force Order*, 16 FCC Rcd 11244, at para. 175.

³⁰ See *id.*, 16 FCC Rcd 11244, at para. 175-176.

³¹ See *id.*, 16 FCC Rcd 11244, at para. 174.

³² See 47 U.S.C. § 254(b)(3).

³³ See *Alenco Commun. Inc. v. FCC*, 201 F.3d 608, at 622.

³⁴ See *id.* at 619.

technologically neutral manner. To do otherwise will only grow the fund unnecessarily and encourages inefficiency, to the detriment of all consumers, most notably those in high-cost and/or rural area.



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Positions held at CenturyTel

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David Cole is responsible for CenturyTel's accounting, end-user and carrier billing, revenue assurance and financial planning.

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**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of)	
)	
)	
Federal-State Joint Board on Universal)	CC Docket No. 96-45
Service)	FCC 04J-2

**Prepared Testimony of David D. Cole On Behalf of
Independent Telephone & Telecommunications Alliance Before the
Federal-State Joint Board on Universal Service**

I. BACKGROUND AND SUMMARY OF TESTIMONY

My name is David D. Cole. I serve as Senior Vice President, Operations Support for CenturyTel, Inc., a communications services provider based in Monroe, Louisiana, serving rural communities in 22 states. I am testifying today on behalf of the Independent Telephone & Telecommunications Alliance ("ITTA"), an organization of twelve midsize incumbent local exchange carriers ("ILECs"), which collectively operate in more than 40 states and provide local exchange and exchange access service to more than ten million customers. ITTA's member companies are integrated providers offering a broad range of services to their customers, including interexchange, Internet, broadband, video, and wireless services. Most ITTA member companies qualify as rural telephone companies within the meaning of Section 3(37) of the Communications Act of 1934, as amended (the "Act").¹

ITTA appreciates the opportunity to testify at this hearing. The issues being addressed by this panel are critical to the advancement of universal service. By this testimony, ITTA urges the Joint Board to recommend that the Federal Communications Commission

¹ 47 U.S.C. §153(37).

("FCC") modify its "Safety Valve" rules so that carriers acquiring rural exchanges are not penalized for investing in rural high-cost areas. ITTA further requests that the Joint Board recommend revisions to the method for calculating support for competitive eligible telecommunications carriers ("CETCs") such that they receive support based on their own costs, not those of the ILEC. These actions are necessary to better target rural high-cost support to areas where it is truly needed, create rational economic incentives for investment (and eliminate disincentives under the current system), achieve greater efficiencies, and better control growth in the universal service fund.

II. SECTION 54.305 AND THE "SAFETY VALVE" SHOULD BE MODIFIED SO INVESTMENT IN RURAL HIGH-COST AREAS IS NOT DISCOURAGED

ITTA members are acutely aware of the hurdles that carriers face immediately following acquisition of rural lines. Within the past five years alone, ITTA members have purchased several million lines from the Bell Operating Companies ("BOCs") (including GTE, now part of Verizon), and many of those lines are in rural areas.² These acquisitions routinely have been approved by the FCC and have been found to be in the public interest. ITTA members support the concept of the current "Safety Valve" mechanism, but the present timing and method of calculating support creates disincentives to investment in these acquired exchanges and must be changed.

The "Safety Valve" mechanism set forth in the FCC rules currently provides for up to 50 percent of any positive difference between the purchasing carrier's index year expense

² See, e.g., *ALLTEL Corporation, Petition for Waiver of Section 61.41*, Memorandum Opinion and Order, 17 FCC Rcd 27,694 (Wir. Comp. Bur. 2002) (ALLTEL Kentucky Acquisition and CenturyTel Alabama and Missouri acquisitions).

adjustment, at the end of its first year of operations, and subsequent year expense adjustments.³

Thus, rural carriers are ineligible for support for any investments made and expenses incurred in the first year after it acquires lines from another carrier. These rules are not neutral, but penalize buyers and customers in high-cost areas neglected by the operators serving larger study areas.

A. The Current Safety Valve Rule Penalizes Carriers That Make Expenditures in Acquired Markets During the First Year After the Acquisition, and Does Not Adequately Compensate Carriers Thereafter

There is no policy justification to discourage the acquisition of rural exchanges—especially from those operated by the BOCs. Rural customers reap substantial, concrete benefits from such acquisitions because carriers that buy rural exchanges typically make substantial investments and improvements in such exchanges in the first year after acquisition. Not surprisingly, those investments are largely driven by customer demand and, in some cases, by state public service commissions. Carriers acquiring rural exchanges typically perform immediate, extensive maintenance to bring long-neglected telecommunications facilities out of disrepair. This may involve re-working plant that extends from the loop itself all the way into the central office. In most cases when the sale of such access lines are first announced, consumer anticipation is high with the expectation that improvements and new service offerings will be swift in coming. The first year following an acquisition is critical to consumers and the buyer, and support for immediate expenditures should be available in the first year. It is axiomatic that a seller ceases investing in rural exchanges as soon as it decides to sell them—often several years before the sale actually closes. In the first year following an acquisition, the buyer must address the full extent of needed improvements and expenditures, and typically makes long-postponed upgrades to plant and services.

³ 47 C.F.R. § 54.305.

The months immediately preceding and following the acquisition is also the period of time that the buyer is most at risk to competitors picking off the most attractive customers – the buyer cannot afford to delay these much-needed improvements. Yet the Safety Valve currently rewards only those buyers who wait a year before making expenditures, by comparing expenditures in the first year to expenditures for subsequent years. As experience repeatedly demonstrates, however, essential first-year expenditures are necessary to rehabilitate neglected rural infrastructure and carriers should be given every incentive to make those expenditures.

In addition to National Telecommunications Cooperative Association (“NTCA”), ITTA and other rural interests, an independent analyst (Legg Mason) has pointed out these shortcomings of the Safety Valve mechanism. In its study examining the phenomenon of BOC sales of exchanges to independent, often rural, carriers,⁴ Legg Mason found that BOC exchanges being sold were among the most depreciated among all BOC exchanges.⁵ These properties need substantial infusions of cash – Legg Mason estimates an average of \$400 per line – to fund investment in new and improved plant and equipment in order to provide high-quality services to

⁴ Legg Mason, *Reshaping Rural Telephone Markets: Financing Perspectives on Integrating Acquired Access Lines*, at 21 (Fall 2001) (“2001 Legg Mason Report”) (“In recent years, we believe that RBOC managements have directed resources to urban areas, where long-term strategic positioning is key and higher return on investment can be generated. As a result, it appears that rural investments have been minimal and, when the companies are pressed to upgrade non-urban properties, divestiture becomes a more logical outcome.”).

⁵ See, e.g., *id.* at 107, 156 (“[O]n the subject of infrastructure, the data are stunning about the distressed nature of the RBOC rural plant. Depreciation is 60%-75% of total telecommunications plant in service for the most part, many of the exchanges have remote switches, and the divested properties are often ‘orphaned remotes,’ which means that the buyer must then rearchitect the plant or install new host switches.”; “[V]irtually every acquirer of RBOC lines has reported difficulties with cabling and serving electronics.”).

rural America.⁶ The experience of mid-size companies confirms Legg Mason's findings. As Valor Telecommunications of Texas, L.P. ("Valor") documented in its 2003 petition to the FCC for waiver of the Safety Valve rules, the lines that it bought from GTE in Texas were 70 percent depreciated, compared to the lines retained by GTE that were only 48 percent depreciated.⁷ In less than three years of operation, Valor invested over \$100 million in the Texas lines acquired from GTE, and still had over two years remaining in its five-year facilities investment plan.⁸

Furthermore, state commissions, which are aware of past infrastructure neglect by larger selling carriers, have requested or required companies buying those properties to make needed investments and maintenance expenditures—often as a condition of approval of sale. For instance, the Wisconsin state commission required CenturyTel to replace the seller's highly outdated switches as one of the conditions on its approval of CenturyTel's acquisition of lines in that state. In Missouri and Alabama, the state commissions required CenturyTel to freeze local rates for two years notwithstanding the need to update switches and other telecommunications infrastructure.

It borders on unconscionable that the current Safety Valve rule, due to timing triggers, actually works to dissuade carriers from making needed improvements to newly acquired exchanges and to delay by a year or more access by affected rural consumers to the basic level of services that such investment would provide. Section 54.305 is by no means an incentive to "gold plate" a rural network – carriers are motivated to invest to improve service quality, though they may recover only a fraction of the added expenditures they make in the

⁶ *Id.* at 107.

⁷ Valor Telecommunications of Texas, L.P., Petition for Waiver of Section 54.305 of the Commission's Rules, CC Docket No. 96-45, at 9 (filed Apr. 30, 2003).

⁸ *Id.*

acquired exchanges. Therefore, carriers have no economic incentive to invest monies that are not necessary for the provision of basic services. Further guarding against abuse, rural ILECs make all investments in advance and are subject to rigorous accounting requirements to justify their receipt of support. Carriers should be given a reasonable incentive to improve telecommunications services in the exchanges they acquire without unnecessary delay.

B. ITTA Supports Modifications to the Safety Valve Mechanism

Section 54.305 of the FCC's rules ensures transactions will not occur purely to increase the amount of support to a particular exchange. However, the FCC modified this rule because the rule did not provide adequate support for substantial investments made in acquired exchanges, which penalized both acquiring carriers and their customers.⁹ Unfortunately, as well-intentioned as the Safety Valve concept was, the FCC did not go far enough in adopting the Safety Valve as currently structured, because it does not provide any cost recovery for additional expenditures in the critical first year following the purchase of rural exchanges.

Additional support is needed, as has been widely recognized, requiring modifications to the Safety Valve mechanism. In a petition for reconsideration of the *RTF Order*, NTCA asked the Commission to amend Section 54.305 to allow acquiring carriers to receive Safety Valve support for first year investments in newly acquired exchanges.¹⁰ ITTA supports this petition, which has been pending before the FCC for more than 3 years. In

⁹ The Joint Board explained, "In its *Rural Task Force Order*, the Commission modified [Section 54.305 of its rules] to permit an acquiring rural carrier to receive additional high-cost loop support (i.e., "Safety Valve" support) for substantial investments it made in acquired exchanges." *Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission's Rules Related to High-Cost Universal Service Support*, Public Notice, FCC 04J-2 at ¶ 48 (rel. Aug. 16, 2004) (citing *Rural Task Force Order* at ¶ 91-119).

¹⁰ NTCA Petition for Reconsideration and Clarification, CC Docket 96-45, (filed July 5, 2001).

addition, the recently filed ICF plan for Intercarrier Compensation and Universal Service Reform Plan (the "ICF Plan"), drafted by a diverse cross-section of the industry that includes interexchange carriers, BOCs and competitive local exchange carriers,¹¹ supports a "neutral" policy toward sales of rural exchanges, and supports modifying the Safety Valve so rural high-cost loop support is available in the first year, and so additional support (for non-loop expenditures) is available as well.¹²

The ICF Plan proposes the following modifications. *First*, the acquiring carrier should be eligible for support immediately following the acquisition of rural exchanges based on a showing of actual investment in the acquired properties.¹³ *Second*, the Commission should measure the baseline cost-per-loop in an acquired exchange on the costs of the *seller* at the time of the acquisition. Measuring the baseline by the seller's costs will best demonstrate the increased costs incurred by the buyer subsequent to the acquisition, and will provide an immediate basis for support. *Third*, the acquiring carrier should receive 75 percent of the difference between its average loop cost and its baseline loop cost during the first year after acquisition, and 50 percent in subsequent years as under the current rule. The ICF Plan also proposes a second, comparable, Safety Valve mechanism that would provide support to the acquiring carrier for non-loop expenditures.¹⁴

Under the ICF Plan, the additional support that is advocated still would compensate carriers only for a fraction of their additional expenditures in acquired exchanges, but would remove the current disincentives to acquisition of, and investment in, high-cost rural

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¹² ICF Plan, CC Docket No. 01-92 (filed Oct. 5, 2004).

¹³ *Id.* at Exhibit A, pp. 80-81.

¹⁴ *Id.* at 23-24.

exchanges. ITTA therefore supports the ICF proposed changes to the Safety Valve mechanism and requests that the Joint Board recommend these modifications to the FCC.

III. CETCS SHOULD RECEIVE SUPPORT BASED ON THEIR OWN COSTS, NOT THOSE OF THE ILEC

At a time when universal service funding is under attack on multiple fronts, the FCC and Joint Board must not lose sight of the statutory purposes of the high-cost fund -- providing specific, predictable and sufficient support to ensure comparable services are available at comparable prices in rural and urban areas.¹⁵ ITTA understands concerns that have been raised about growth in the universal service fund. However, rural ILECs are not the major cause of increases in the overall high-cost fund. The high-cost loop fund is capped and the national average cost-per-loop is frozen. ILEC high-cost loop support will actually decline in 2005, for the first time, due to line loss, while total available support remains capped for ILECs (despite the steady increase in actual average per-line costs).

ITTA members are troubled by the tone of recent releases by the Joint Board that propose to rein in "uncontrolled" growth in the universal service high-cost fund by cutting funding to rural ILECs, the carriers-of-last-resort in many rural communities.¹⁶ Such proposals are not rooted in the realities of providing service to rural communities and are contrary to Section 254 of the Act. Section 254 of the Act makes clear that universal service must be the goal of the universal service fund.

¹⁵ 47 U.S.C. §§ 254(b)(3), (5).

¹⁶ See generally *Federal-State Joint Board on Universal Service*, Recommended Decision, FCC 04J-1 (rel. Feb. 27, 2004) ("Recommended Decision"); Public Notice.

CETC support is currently at about seven percent of the high-cost fund, over half a billion dollars annually,¹⁷ and it is the fastest growing category of federal support.¹⁸ It is also the only form of federal support that is not capped based on relative costs. As explained in a recent Legg Mason report, *“the size of the universal service fund . . . would not be a major concern if it were not for the dramatic growth in CETC payments over the last two years and the potential expansion in the next few years.”*¹⁹

That is why it is critical to look at CETC requests for funding as part of the responsible management of the fund. An important part of checking growth in the universal service high-cost fund, while continuing to promote universal service in rural areas, is to require CETCs to justify support based on their own costs, not the costs of the ILEC. While more and more CETCs are getting support at the same level as the ILEC, they still are not required to demonstrate that the support is being used to provide a service that is comparable to the service the ILEC provides. This is a fundamental measure of consumer-focused accountability that should be recommended by the Joint Board. ILEC costs, investment and related recovery are there for all to see. CETCs should also be required to demonstrate their costs justify funding, and what amount of funding would be “sufficient” under the Act. Recent pressures and

¹⁷ Legg Mason Wood Walker, Inc., Universal Service Financial Analysis, at 11-12 (June 25, 2004) (estimating approximately \$44.74 million of funding per month to CETCs) (“2004 Legg Mason Report”).

¹⁸ Comments of the National Association of State Utility Consumer Advocates on the Recommended Decision of the Federal-State Joint Board on Universal Service, CC Docket No. 96-45, at 8-9 (filed Aug. 6, 2004) (“These numbers show that CETCs and especially wireless ETCs are consuming an ever-growing amount of high-cost funds. Wireless ETC support is the fastest growing portion of the high-cost fund. In fact, 66% of the growth of the fund over the last four quarters can be attributed to CETCs.”).

¹⁹ 2004 Legg Mason Report at 5 (emphasis in original).

controversies surrounding the administration of universal service funds dictate that center piece of any pending reforms should be strict oversight of rapidly increasing CETC disbursements.

Accountability measures under the current rules are not sufficient to ensure that CETC support is directly related to costs they incur in providing service to high cost areas. Given current standards in use to designate CETCs, it is not possible to determine what costs CETCs incur serving rural areas or how those costs relate to incumbents' costs. While, for example, it is certain that wireless CETCs have lower legal and regulatory costs than their wireline counterparts, existing accountability measures provide no basis for accurately assessing CETCs' actual costs of providing service.

In addition, there is what has been termed by some the "customer list" problem.²⁰ That is, as soon as a wireless carrier receives its CETC designation, the new CETC receives support for its entire existing customer list equal to the per-line support of the ILEC, without any effective accountability for those lists or without any requirement to expend the newly acquired resources in serving those lines. Given that current standards in many states for CETC designation are quite liberal, CETCs are effectively compelled to seek universal service support to maximize profits, even though they may not require such support to continue to compete.²¹

In some instances, CETCs are receiving more universal service support than the incumbent because multiple CETCs in the market are submitting substantially more lines for

²⁰ Remarks of Commissioner Kevin J. Martin, Federal Communications Commission, to the Santa Fe Conference of the Center for Public Utilities Advisory Counsel, Santa Fe, New Mexico, at 6 (March 18, 2003); McLean & Brown, *Issue Update, Special Edition, USF Portability – Getting it Right*, at 2 (June 25, 2002).

²¹ Comments of the Rural Telecommunications Associations, CC Docket No. 96-45, at 7 (filed Aug. 6, 2004) ("Even if the management of a competitive carrier knows that their costs are low enough to compete effectively without additional support, they are compelled by their fiduciary duty to seek ETC designation so as to maximize profits and avoid lost opportunities to obtain support.").

support than there are households (or, in some cases, even people) in the study area. The National Exchange Carrier Association recently provided the example of universal service fund abuse in Iowa, where, in the Batavia study area, wireless carriers sought support for 927 customers, *nearly twice the population of the study area*.²² NECA further commented that federal support is apparently being provided for “two mobile phones for every man, woman and child in Batavia.”²³ Similarly, SBC has noted that Western Wireless sought support for over 30,000 working loops on the Pine Ridge Reservation in South Dakota in the first quarter 2003 despite the fact that the Reservation had fewer than 15,000 residents and fewer than 4,000 housing units.²⁴

CenturyTel also has first-hand experience with this phenomenon. CenturyTel’s only study area in Arizona has 1,933 wireline loops, but Smith Bagley, a wireless CETC, submits 2,730 loops for funding and receives 41 percent more support than CenturyTel in CenturyTel’s Arizona study area.²⁵ Considering the concerns of the Joint Board regarding the size of the universal service fund, it is hard to imagine that the public interest is served by the absence of the reasonable accountability measures for CETCs. This issue is exacerbated by the fact that wireless CETCs commonly file petitions to redefine ILEC service areas so that the

²² Comments of the National Exchange Carrier Association, Inc., CC Docket No. 96-45, at 14 (filed Aug. 6, 2004).

²³ *Id.*

²⁴ Comments of SBC, CC Docket No. 96-45, at 10-11 (filed May 5, 2003) (citing Comments of South Dakota Telecommunications Association, WT Docket No. 02-381 (filed Feb. 3, 2003)).

²⁵ Universal Service Administrative Company, Fourth Quarter Appendices (HC18), available at <http://www.universalservice.org/overview/filings/2004/Q4/default.asp> (visited Sep. 21, 2004).